Fitch Places Fortum's 'BBB' Rating on Rating Watch Negative

Fitch Ratings - Milan - 09 October 2019:

Fitch Ratings has placed Fortum Oyj's Long-Term Issuer Default Rating (IDR) and senior unsecured rating of 'BBB' and Short-Term IDR of 'F2' on Rating Watch Negative (RWN).

The RWN reflects the expected negative impact on the group's risk profile from the acquisition of an additional 20.5% stake in Uniper SE for a total consideration of EUR2.3 billion, resulting in full consolidation of the German utility with a 70.49% stake. Fortum will use both available cash and debt to fund the transaction. The higher perceived business risk of the new consolidated group results in tighter rating sensitivities (negative sensitivity on leverage reduced from 3.8x to 3.2x), which based on our preliminary estimates the group would consistently breach in the absence of managerial actions which in our view would suggest a one-notch downgrade from Fortum's 'BBB' rating.

The finalisation of the transaction, expected by the end 1Q20, is subject to certain conditions, including the approval of the Russian authorities, which has represented an obstacle in the past. We will resolve the RWN when we have visibility of Fortum's strategy and financial policy for the new group.

Key Rating Drivers

Riskier Combined Business Profile: Fitch views Uniper's standalone business profile as riskier than Fortum's, due to its exposure to increasing CO2 prices, which puts pressure on Uniper's coal generation driven earnings and its volatile gas midstream and commodity trading business. Using 2018 as a reference point, the share of coal generation, currently negligible for Fortum, would represent 18% of total generation in the combined new group. Furthermore, Uniper's commodity trading business brings earnings volatility and Fitch would normally not expect this business segment to have any debt capacity at an investment grade level. With both Uniper's and Fortum's FY18 EBITDA (as reported to investors) around EUR1.5 billion, the companies have a broadly similar weight in the assessment of the combined business profile. Generation accounted for around 75% in Fortum's and Uniper's EBITDA.

Leverage Breaches Updated Guidelines: We have based our preliminary estimates on a full consolidation of Uniper into Fortum's accounts for rating purposes, but we will further assess the fairness of this approach based on the actual cooperation between the two companies. The dividend leakage to third parties is properly captured by our funds from operations (FFO). Fortum will use available cash and new debt to fund the purchase and Fitch preliminarily estimates FFO of around EUR2.3 billion and net debt of around EUR9 billion for the new group in 2020, with pro-forma 12 months for Uniper FFO net adjusted leverage expected to be 3.8x (vs. new proposed guideline of 3.2x).

We believe that the group has some potential to generate structurally neutral to positive free cash flow. However, the updated financial policy and target leverage of the larger group will be key in defining the rating.

Uniper's Evolving Corporate Governance: As a consequence of the transaction, Fortum intends to be properly represented on Uniper's supervisory board fairly soon, although we have no visibility on a potential timeline. The supervisory board includes 12 representatives, of which six represent employees, which will not change. Fortum rules out a domination agreement or squeeze-out for at least two years and it targets a
cooperative approach with Uniper in the definition of its business plan. Fitch understands that as of today Fortum does not fully control Uniper, but we believe that this will likely occur in the medium term.

Uniper Large Thermal Genco: Uniper is one of the biggest power producers in Europe with total installed capacity of 34.3 GW, of which 23.5 GW is located in Central and Northern Europe and 10.8 GW in Russia. Uniper’s production mix is more fossil-based than Fortum, as according to our estimates 49% of Uniper’s capacity is gas-fired and 26% coal-fired power plants, while for Fortum coal is negligible and gas represented 38% of production in 2018. The group’s FY18 EBITDA was EUR1,543 million and group-defined net debt to EUR1,456 million.

Strong Nuclear Fleet: In 2018, Fortum generated 23 TWh from its nuclear plants with an aggregate load factor of close to 90%. It owns the Loviisa power plant in Finland and is a shareholder in three other nuclear plants in Finland (Olkiluoto) and Sweden (Oskarshamn and Forsmark). The Oskarshamn unit is jointly owned with Uniper and the contemplated transaction would add to Fortum’s consolidated nuclear capacity. The infrastructure for nuclear decommissioning is well established in the Nordic region, based on very detailed cost estimates. There are already solutions for the final storage sites for which funds are transparently accumulated and segregated externally.

Steady Current trading: Fortum’s 1H19 results developed broadly in line with Fitch’s expectations with EBITDA growth through all segments (+12% yoy). City Solutions has grown less than expected with a negative impact from warm weather, whereas Russia is performing slightly better than our forecast. Prices in the Generation segment have also been volatile with a sharp decline in the power price to EUR35.6/MWh during 2Q from EUR46.9/MWh in 1Q. However, this impact is mitigated with hedging and at end-June 2019, Fortum had hedged 80% of its production at EUR33/MWh for the remainder of 2019.

For Uniper, EBITDA for the first half of FY19 declined to EUR657 million from EUR940 million in 1H18. The decline is largely due to exclusion of positive one-off items in 2018, but also an increase in CO2 prices. Uniper is exposed to both Central European and Nordic power prices, and hedges a large share of its output. At end-June 2019, Uniper had hedged 85% and 75% of its power output in Germany and the Nordics, respectively, for the remainder of 2019. Like Fortum, Uniper benefits from capacity payments in Russia, which stabilise earnings.

No GRE Impact: Fortum is 50.8%-owned by Finland (AA+/Positive). We assess all factors under our Government-Related Entities (GRE) Criteria as ‘weak’ or ‘moderate’, resulting in no uplift to Fortum’s ratings.

Derivation Summary

Compared with the wider top European utilities peer group, Fortum’s share of regulated and contracted income is among the lowest. Fortum’s good quality fleet of mainly hydro and nuclear plants will weaken as a consequence of Uniper’s large thermal exposure. Among Nordic peers, Statkraft AS (BBB+/Stable) benefits from its long-term contracts and low-cost hydro asset base as well as a one-notch uplift for sovereign support. Vattenfall AB (WD; BBB+/Stable before withdrawal in May) is more integrated through its regulated network operations (representing almost 30% of EBITDA), placing its rating one notch above Fortum’s.

Based on our assessment of Fortum’s strong financial flexibility and adequate financial structure, the higher of the two Short-Term IDR mapping to the Long-Term IDR has been assigned. A downgrade of the Long-Term IDR would lead to a downgrade of the Short-Term IDR to ‘F3’.

Key Assumptions

Fitch’s Key Assumptions Within Our Rating Case for the Issuer (New Perimeter)
- EBITDA of the new group to be in the range of EUR3.0 billion-EUR3.2 billion in 2020-2023
- Annual capex at around EUR1.2 billion-EUR1.3 billion
- 3% cost of new debt incurred during the plan horizon
- Dividends distributed by Fortum at around EUR1 billion per year
- Total dividends distributed by Uniper increasing to more than EUR500 million from 2021, of which 29.5% is distributed to third-party minorities

**RATING SENSITIVITIES**

Developments That May, Individually or Collectively, Lead to Positive Rating Action (Affirmation and Stable Outlook)

- We would affirm the rating if the company demonstrated that it was on track to achieve FFO adjusted net leverage below 3.2x on a sustained basis, FFO fixed charge cover above 5.0x on a sustained basis and in the absence of significant deterioration of the political, economic or regulatory environment in Russia or significant structural decline in Nord Pool power prices

Developments That May, Individually or Collectively, Lead to Positive Rating Action (Upgrade)

Rating upside is limited due to risks related to the integration of the Uniper business and the incremental debt related to the acquisition. However we could upgrade the rating if:

- FFO adjusted net leverage below 2.0x and FFO fixed charge cover above 6.0x, all on a sustained basis

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 3.2x on a sustained basis, FFO fixed charge cover below 5.0x on a sustained basis
- Significant deterioration of the political, economic or regulatory environment in Russia or significant structural decline in Nord Pool power prices
- Problems with Uniper's integration changing our view of a consolidated perimeter for the ratings.

**Liquidity and Debt Structure**

Adequate Liquidity: Fortum's reported cash and cash equivalents stood at EUR1.3 billion at end-June 2019 and with committed unused credit lines of around EUR1.8 billion (maturing in June 2023), total available liquidity was EUR3.1 billion. This compares with short-term interest bearing liabilities of EUR535 million at end-June 2019. Furthermore, Fortum has secured funding for the announced acquisition of the additional stake in Uniper through new loan, which further supports Fortum's liquidity.

Uniper's liquid funds at end-June 2019 amounted to EUR717 million. Combined with a EUR1.8 billion available loan facility (maturing in 2023), Uniper's liquidity is sufficient to cover short-term liabilities of EUR1.4 billion (including lease liabilities).
ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

**RATING ACTIONS**

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Additional information is available on www.fitchratings.com

**Applicable Criteria**

Sector Navigators (pub. 23 Mar 2018)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Short-Term Ratings Criteria (pub. 02 May 2019)
Parent and Subsidiary Rating Linkage (pub. 27 Sep 2019)

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